Testimony
of
Robert B. Fagenson

The Specialist Association
of the
New York Stock Exchange

on

H.R. 1053

The Common Cents Stock Pricing Act of 1997

Before the

Subcommittee on Finance and Hazardous Materials

of the

Committee on Commerce

House of Representatives

April 16 , 1997

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I am Robert B. Fagenson, Managing Partner of Fagenson, Frankel & Streicher, a New York Stock Exchange specialist firm. I appear before you today in my capacity as a specialist and a member of The Specialist Association of the NYSE.

On behalf of the Association, I want to express my thanks for this opportunity to testify before the Subcommittee on H.R. 1053, the Common Cents Stock Pricing Act of 1997. The bill would require the Securities and Exchange Commission to conduct a rulemaking proceeding within a year after enactment to "require quotations in dollars and cents for transactions in equity securities, as necessary or appropriate in the public interest . . . ." The bill is intended to compel the SEC to change the traditional trading increments for equity securities from fractions of a dollar to dollars and cents (commonly referred to as "decimalization"), leaving it to the SEC to determine the minimum number of cents per share that should characterize bid and offer quotations and last sale reports in our markets. The purpose of this change, as explained by the bill's sponsors, is to eliminate minimum spreads between bid and asked prices expressed in fractions that are thought to "punish [ ] investors and reward [ ] traders."[1]

The Association cannot at this time support a change in trading increments for U.S. equity securities from fractions of dollars to cents. This is so even though we believe that, at least in the short run, our specialist community would benefit from such a change. We do, however, have substantial concerns about the long-term effects of decimalization on the markets, particularly a

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[1] Remarks of Chairman Michael G. Oxley concerning H.R. 1053 at a March 13, 1997 press conference.

forced change to decimalization that might have the effect of lowering trading increments to as little as a penny.

Our assessment of a move to decimalization, based on the information we have now, is as follows:

1. Decimalization and any consequent narrowing of spreads between bid and offer prices would tend to reduce the profitability of payment for order flow, self-preferencing and internalization of retail orders in listed stocks, all practices that divert order flow from the NYSE to the Cincinnati Stock Exchange and the over-the-counter market and, thus, away from maximization of the opportunity for customers to transact directly with each other instead of trading with a dealer, the kind of direct customer interaction that trading on the NYSE affords. (When buying and selling customers deal directly with each other, of course, neither of them pays the spread to a dealer.) .

2. Decimalization and any resulting narrowing of bid-ask spreads would tend to reduce the ability of regional stock exchange specialists that trade our stocks to do so profitably — again with the result that order flow now diverted to those exchanges and away from the primary market would be returned to the NYSE.

3. Decimalization, especially if the most common trading increment were to be reduced from an eighth (or 12.5 cents) to a penny, would increase dealers' ability when trading for their own accounts, including our own ability, to step in front of customers to seize favorable trading opportunities with significantly lower risk and at lower cost than is the case today.

4. Decimalization would reduce the transparency of the markets by cluttering bid-offer quotation displays with short-lived bids and offers for small amounts of shares (likely to flicker in and out of existence too rapidly to permit public customers to take advantage of apparent price improvements) and by disguising trends in stock prices by increasing the number of trades reported and displayed on the consolidated tape and in last sale reporting devices at very small changes in price.

The first of the foregoing consequences, in our view, would be altogether favorable for us as primary market specialists and for public customers (even though some others think that payment for order flow, preferencing and internalization are beneficial or at least acceptable practices — views with which we have long disagreed).

The second consequence, making it more difficult for the regional stock exchanges and their specialists to compete with the NYSE, would benefit us, at least in the short term, and likely would benefit public customers. Regional exchanges would be less able to compete, we believe, because decimalization and any consequent narrowing of spreads would adversely affect regional specialists' dealer profits and, thus, their ability to make markets. (Regional exchanges do not have as great a flow of public orders as our market, and, as a result, regional exchange specialists derive most of their profits from "spread trading," buying at the bid and selling at the offer. Because the NYSE has a far greater flow of public orders and our specialists must yield priority to those orders at a given price, our specialists are not dependent on "spread trading" for profits.)

We confess that we have reservations about the long-term effects of possible elimination of regional exchange competition with the NYSE because our market system is a whole seems to have benefitted from such competition, even if that competition has not always seemed "fair" to us. If decimalization were to lead to the demise of regional exchange competition, we are concerned that greater SEC intervention in our market through regulation might be thought to be necessary — an undesirable result. Market changes resulting from market forces and competition seem to us preferable to market changes engineered by the SEC, a government agency.

The third and fourth consequences of moving to decimalization seem unfavorable to us because they could be extremely harmful to investor confidence in our markets.

Today a dealer can obtain precedence over public orders to buy or sell a stock only by outbidding or out offering those public orders by the standard trading increment — generally, an eighth or 12.5 cents. As you might expect, a dealer's assessment of his ability to profit from a transaction in which he must "pay up" by 12.5 cents is different than it would be if the dealer were required to "pay up" only by a penny. If the dealer's hoped-for market movement fails to occur, the dealer would be able to liquidate his investment at a loss of only a penny rather than 12.5 cents. When one considers that, on average, over the course of a year, specialists make between 2 and 3 cents profit on shares that they buy and sell for their own accounts (taking into account all trades, some profitable and some resulting in losses), the existing standard trading differential of an eighth, or 12.5 cents, forces the specialist to risk 12.5 cents to obtain the opportunity to earn less than 3 cents, on average. When the specialist takes that risk, the specialist also benefits the other side of the trade because a buyer pays 12.5 cents less or a seller receives 12.5 cents more than otherwise would have been the case -- that is, the specialist provides a significant degree of price improvement. If the differential were to be lowered to, say, 1 cent, the specialist would take much less risk and the other side of the trade would benefit only to the extent of a penny rather than 12.5 cents.

Let me illustrate the problem that we fear could occur if decimalization were to result in penny increments for stock trading.

Today, XYZ stock trades in increments of 1/8th. Assume that the highest bid for XYZ is 20 and that the lowest offer for that stock is 20 1/4. If a public customer seeks to buy XYZ at 20 (by entering a limit order to buy at that price or any lower price), a dealer also seeking to buy XYZ can obtain precedence over the customer only by outbidding that customer by 1/8th — *i.e.*, by bidding

20 1/8 for XYZ. If the dealer does so, and buys XYZ at 20 1/8, anticipating that XYZ will trade at a higher price, and if XYZ does not trade at that higher price after all, the dealer may liquidate his position only by selling. At best, assuming that the public customer seeking to buy XYZ is still willing to pay 20, the dealer will realize a 1/8th loss (or 12.5 cents). This potential for loss operates as a significant constraint on the dealer's ability to take precedence over public customers -- and as a kind of guarantee that when a dealer does outbid or outoffer public customers, the bid or offer price will be materially improved.

Now, assume that, in a decimalized world, XYZ trades in increments of a penny and that XYZ is bid at 20 and offered at 20.24. (There is no particular reason, by the way, to expect that decimalization will produce narrower spreads — or that, even if it does lead to narrower spreads, that the size of bids and offers will be as large or that the market will be as liquid and deep as it is today.) Assume that a public customer seeks to buy XYZ at 20 and that a dealer who believes that the price of XYZ will increase can step ahead of the customer by bidding 20.01 for XYZ. If the dealer buys at 20.01 and the expected increase in the price of XYZ does not occur, the dealer again must sell. Assuming that the public customer seeking to buy XYZ is still bidding 20, however, the dealer will realize only a 1 cent loss — no disincentive at all to stepping ahead of the public customer when the dealer believes there is any reasonable prospect of gain.

Public investors do not expect to be taken advantage of by dealers when those investors buy and sell listed stocks on an exchange. The so-called "time and place" advantages of market professionals on the floors of United States securities exchanges were regarded with great alarm by the Congress and the SEC in the 1960s and early 1970s prior to the elimination of "floor trading" by Section 11(a) of the Securities Exchange Act of 1934 — thought to have been needed because SEC regulation of floor trading prior to the Securities acts Amendments of 1975 was regarded as insufficient to control or eliminate the inherent unfairness of floor trading. Floor traders obtained trading advantages over members of the public through their greater access to current market information on exchange floors and their ability to implement trading decisions more rapidly and more cheaply than was possible for public customers. Decimalization, particularly in a manner that reduces the normal trading increment to a penny (or anything close to a penny), would resurrect all of the problems associated with market professionals' "time and place" advantages in times past.

We fear that any significant increase in the ability of market professionals to obtain precedence over public customers -- to trade ahead of them -- and in the incentive for market professionals to do so (a consequence of reducing their risks), would tend to undermine public confidence in the fair operation of our markets and could discourage market participation by individual investors.

We also worry that the enormous efforts made over the past 22 years by the SEC, the NYSE and the other securities exchanges, and the National Association of Securities Dealers to develop and perfect the consolidated reporting of last sale information and the composite display of bid and offer quotations from all markets could be significantly undone by decimalization, particularly if decimalization results in trading increments as low as a penny. We have no doubt that, at some considerable cost, the quotation and last sale reporting and display mechanisms used throughout the nation and the world to obtain up-to-the-second bid and offer and last sale information concerning our listed stocks could be modified to accommodate decimalized pricing within a reasonable period. We are very concerned, however, that the hard-won transparency of our markets could be seriously degraded by flickering, rapidly changing and functionally inaccessible bid and offer displays, varying only by a penny or so, and by a clutter of similarly small price changes in last sale reports — all tending to disguise rather than reveal the current state and trend of the market. This effect could be particularly severe in the case of the consolidated quotation system. If decimalization were to lead to a significant reduction in spreads between bid and asked prices, we do not believe that the size of quotations (the number of shares bid for or offered) — indicating market depth and, to some extent, liquidity, a factor of much greater importance to all market participants than the amount of the bid-ask spread at any particular price level — would be as large as the size associated with today's quotations.[2]

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[2] See, Lee and Ready, Spreads, Depths, and the Impact of Earnings Information On Intra Day Study, 6 The Review of Financial Studies (No. 2), 345 (1993).

Together, the foregoing developments could have a severe adverse effect on the vitality of our markets and, indirectly, on the capital raising process. For these reasons, notwithstanding the apparent short-term benefits to us, as primary market specialists, we view H.R. 1053 as a potentially dangerous initiative, one that we cannot support without further assurance that its passage and implementation would improve rather than degrade our markets. Consequently, we urge the Subcommittee to take the most searching look at the consequences of decimalization, satisfying itself that the bill cannot have the damaging effects that alarm us. We are unable, at this time, to provide any comfort in this regard. We hope, however, that our testimony has alerted the Subcommittee to at least some of the potential pitfalls of the course of action contemplated by the bill.

I would be pleased to respond to questions.

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